Backgrounder
Published by The Heritage Foundation
No. 2306
August 3, 2009

Seven Myths About Taxing the Rich

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President Barack Obama plans to raise the top two income tax rates from their current 33 and 35 percent levels to 36 and 39.6 percent, respectively. This would undo the 2001 and 2003 tax cuts for Americans earning more than $250,000 ($200,000 for singles) and return the top rates to the levels of 1993 to 2000 during the Clinton Administration.

In addition to these tax hikes, the House of Representatives' Ways and Means Committee, led by Chairman Charlie Rangel (D–NY), favors another tax to fund the government takeover of the health care system. The "Rangel plan" would levy a 1 percent surtax for married couples earning between $350,000 and $500,000 a year, a 1.5 percent surtax on couple incomes between $500,000 and $1,000,000, and a 5.4 percent surtax for couples earning more than $1,000,000. For singles, the surtax would kick in for earners making more than $280,000 a year, $400,000, and $800,000, respectively. It would be phased in beginning in 2011 and could rise higher in future years if Congress decides it needs more revenue to fund its government-run health care system.[1] Contrary to arguments made by proponents of these tax hikes, tax increases in the early1990s did not lift the economy to the highs experienced later in the decade.

President Obama's and Chairman Rangel's tax hikes would increase the progressivity of the already highly progressive tax code. High-income earners pay substantially higher tax rates than do lower-income earners. If passed, this increased progressivity will damage economic growth by lowering the incentives to work,

Talking Points

- Raising taxes on the rich, as proposed by President Obama, would increase the progressivity of the already highly progressive tax code. It would also damage economic growth by stifling job creation, further slowing the growth of already stagnant wages.
- Some see raising taxes on the rich as a silver bullet for fixing fiscal woes. But raising taxes on the rich badly damages the economy.
- Tax hikes on the rich will not alleviate the deficit—it will lead to larger deficits.
- The 2001 and 2003 tax cuts did not cause today's deficits—spending increases caused them.
- The top 20 percent of earners already pay close to 90 percent of all income taxes.
- Tax hikes on the rich hit small businesses hard. Over 70 percent of small business income is subject to the top two income tax rates. Raising these rates will hurt the businesses that are the primary engine for job growth in the U.S.

This paper, in its entirety, can be found at:
www.heritage.org/Research/Taxes/bg2306.cfm

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

The Heritage Foundation
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save, and invest. This will stifle job creation, further slowing the growth of already stagnant wages.[2]

Those who support this tax increase point to several arguments to boost their case. But when these arguments are scrutinized, it is clear they do not hold up. Tax hikes on the rich will not balance the budget or close deficits. High earners already have a vast majority of the federal income tax burden, and the proposed tax hikes will badly damage the economy at a time when it cannot absorb any new negative shocks.

The President should scrap his plan to hike the top two income tax rates and Chairman Rangel his plan to pile additional tax hikes on high earners. Instead, they should propose to immediately cut spending, including reforming entitlement programs, and extending the 2001 and 2003 tax cuts for all taxpayers. Additionally, they should propose further *cutting* tax rates to help the ailing economy.

What Taxing the Rich Does to the Budget

Myth 1: *Raising taxes on the rich will close budget deficits.*

Truth: *Increasing the progressivity of the income tax code by raising the top two rates will not close the deficit. In fact, it will lead to more revenue volatility, which will lead to larger future deficits.*

A progressive income tax system collects increasing amounts of revenue during periods of economic growth and decreasing revenue during downturns.[3] It does so mostly because of the volatility of high earners' incomes. During periods of economic growth, their incomes rise sharply and they pay increasingly higher taxes. But because much of high earners' income stems from volatile sources, such as capital gains, dividends, business income, and bonuses, their incomes fall just as sharply during economic downturns as they rose during good economic times and they have less income to be taxed.

Unless Congress suddenly develops spending restraint, increasing the progressivity of the tax code will only amplify the volatility of revenue fluctuations and increase future deficits. When revenue increases, mostly from high earners, during periods of economic growth, spending would increase because Congress cannot resist spending additional money. But, as history shows, when economic growth slows and revenues fall, Congress does not cut back on its spending largesse. Larger deficits would occur because the gap between spending and revenue would grow compared to previous recessionary periods.

Even if Congress ignores the long-term implications of more volatility and decides to close the deficits by raising taxes instead of borrowing as it is doing currently, it still cannot do it just by taxing more of high earners' income. Congress would have to decide to raise top rates to levels most Americans would consider confiscatory. In 2006, the latest year of available data, there was $2.2 trillion of taxable income for taxpayers earning more than $200,000.[4] Assuming the amount of income at that level is similar this year, Congress would need to tax 80 percent of that income in order to close the projected $1.8 trillion deficit. Tax rates at such levels would significantly decrease economic activity and taxpayers would likely avoid or evade paying them so the revenue gains would likely never materialize.[5]

1. See Lori Montgomery, "Democrats Agree on Tax Hike to Fund Health Care," *The Washington Post*, July 11, 2009, at *http://www.washingtonpost.com/wp-dyn/content/article/2009/07/11/AR2009071100482.html* (July 15, 2009), and Ryan J. Donmoyer and James Rowley, "Health-Care Bill Would Tax High-Income Americans, Rangel Says," Bloomberg.com, July 11, 2009, at *http://www.bloomberg.com/apps/news?pid=20601087&sid=a7s..ps0_Uc4* (July 15, 2009).
2. Curtis S. Dubay, "Income Tax Will Become More Progressive Under Obama Tax Plan," Heritage Foundation *Backgrounder* No. 2280, June 1, 2009, at *http://www.heritage.org/Research/Taxes/bg2280.cfm*.
3. Congressional Budget Office, "Sources of the Growth and Decline in Individual Income Tax Revenues Since 1994," May 2008, at *http://www.cbo.gov/ftpdocs/90xx/doc9076/05-02-TaxRevenues.pdf* (July 30, 2009).
4. Internal Revenue Service, "Table 1.1—Selected Income and Tax Items, by Size and Accumulated Size of Adjusted Gross Income, Tax Year 2006," at *http://www.irs.gov/pub/irs-soi/06in11si.xls*, (July 15, 2009).
5. Congressional Budget Office, "The Long-Term Economic Effects of Some Alternative Budget Policies," Letter to the Honorable Paul Ryan, May 19, 2008, pp. 8–9, at *http://www.cbo.gov/ftpdocs/92xx/doc9216/Letter-to-Ryan.1.1.shtml* (July 15, 2009).

Who Pays the Largest Chunk of Taxes?

Myth 2: *The rich do not pay their fair share.*

Truth: *The top 20 percent of income earners pay almost all federal taxes.*

The top 20 percent of all income earners pay a substantial majority of all federal taxes. According to the Congressional Budget Office (CBO), in 2006, the latest year of available data, the top 20 percent of income earners paid almost 70 percent of all federal taxes.[6] This share was 4 percent higher than in 2000, before the 2001 and 2003 tax cuts.

When only looking at income taxes, the share of the top 20 percent increases even further. In 2006, the top 20 percent paid 86.3 percent of all income taxes. This was an increase of 6 percent from 2000.[7]

Myth 3: *The income tax code favors the rich and well-connected.*

Truth: *The bottom 50 percent of income earners pay almost no income taxes and the poor and middle-income earners benefit greatly from the tax code.*

This widely propagated myth has found its way to the White House Web site's tax page: "For too long, the U.S. tax code has benefited the wealthy and well-connected at the expense of the vast majority of Americans."[8]

As shown in myth number 2, the top 20 percent pay almost 70 percent of all federal taxes and over 86 percent of all income taxes. It is hard to see how the rich benefit from a tax code they pay almost exclusively.

The bottom 40 percent of all income earners benefit greatly from the income tax code. In fact, they actually pay negative income tax rates because refundable credits, such as the Child Tax Credit and the Earned Income Tax Credit (EITC), wipe out their tax liability and pay out more money to them than they ever paid in.[9]

Because of refundable credits, a family of four in the bottom 20 percent of income earners paid an effective income tax rate of –6.6 percent in 2006. As a result, such a family received $1,300 through the tax code. A family of four in the second-lowest 20 percent of income earners paid an effective tax rate of –0.8 percent and received $408 of income through the tax code.[10]

The stimulus bill created a new refundable credit and expanded three others. This will further reduce the income tax burden of low-income earners, to the extent they can pay less, and increase the income they receive through the tax code.

The income tax burden of low-income earners has trended down for years. In 2006, the bottom 50 percent of all income tax filers paid only 2.99 percent of all income taxes. This was down 57 percent from 1980 levels, when the bottom 50 percent paid 7 percent.[11]

Altogether, historical trends and the recent tax policies in the stimulus likely mean that when the data for recent years is released, the bottom 50 percent of all taxpayers will have paid no income taxes whatsoever.

Myth 4: *It is all right to raise tax rates on the rich—they can afford it.*

Truth: *Just because someone can afford to pay higher taxes does not mean he should be forced to do so.*

The faulty principle of "ability to pay" holds that those who earn more should pay proportionally more taxes because they can afford to do so. Such

6. Congressional Budget Office, "Data on the Distribution of Federal Taxes and Household Income," April 2009, at *http://www.cbo.gov/publications/collections/taxdistribution.cfm* (July 15, 2009).
7. Curtis S. Dubay, "The Rich Pay More Taxes: Top 20 Percent Pay Record Share of Income Taxes," Heritage Foundation *WebMemo* No. 2420, May 4, 2009, at *http://www.heritage.org/Research/Taxes/wm2420.cfm*.
8. The White House.gov, "Issues: Taxes," at *http://www.whitehouse.gov/issues/taxes/* (July 15, 2009).
9. Curtis S. Dubay, "Obama's Stimulus Has 'Spread the Wealth Around': Are Tax Hikes Next?" Heritage Foundation *WebMemo* No. 2354, March 23, 2009, at *http://www.heritage.org/Research/Economy/wm2354.cfm*.
10. Dubay, "Income Tax Will Become More Progressive Under Obama Tax Plan."
11. Gerald Prante, "Summary of Latest Federal Individual Income Tax Data," Tax Foundation *Fiscal Fact* No. 135, July 18, 2008, at *http://www.taxfoundation.org/news/show/250.html* (July 15, 2009).

thinking can be a slippery slope because, technically, virtually anyone can afford to pay more taxes. The ability-to-pay principle has no grounding in economics, as it relies on a completely subjective judgment of fairness.

The tax code should collect revenue in the least economically damaging way possible. Raising rates on the rich damages economic growth because it reduces the incentives to work, save, invest, and accept economic risk—the ingredients necessary for economic growth.

Raising taxes on the rich hurts workers at all income levels—especially low- and middle-income earners. The rich are the most likely to invest. Their investment allows new businesses to get off the ground or existing businesses to expand. This creates new jobs and raises wages for Americans at all income levels. Taxing more of their income transfers money to Congress that they could otherwise have invested. This means the economy forgoes new jobs and higher wages that the investment would have created for less effective government spending.

There is a tax code that can collect more from the high earners than from the lower earners without being a barrier to economic growth: Under a flat tax, a taxpayer who earns 100 percent more than another taxpayer pays 100 percent more taxes, but faces no disincentive to earn more since he will pay the same rate on every additional dollar earned.[12]

The Economic Impact of Higher Tax Rates

Myth 5: *Higher tax rates in the 1990s did not hurt economic growth, so it is all right to raise them to those levels again.*

Truth: *High tax rates in the 1990s were a contributing factor to the 2001 recession and returning to those rates will damage the already severely weakened economy.*

The economy boomed during the 1990s for a number of reasons. One key factor was an advance in information technology. Computers, cell phones, the Internet, and other technological advances made businesses more efficient. This increased profits and wages and created numerous new jobs.

The 1997 tax cut that lowered tax rates on dividends and capital gains from 28 to 20 percent was also a major factor helping fuel the economic growth of this period. It strengthened the already strong gains from the technology boom. The impressive growth of the S&P 500 index after its passage is testimony to that fact. In the year before the tax cut, the S&P 500 index increased by 22 percent. In the following year, it increased by more than 40 percent.

The economic benefits of the technological advances and lower taxes on investment were strong enough to overcome the negative impact of the higher income tax rates and the economy exhibited impressive growth—initially. Even though the economy overcame high income tax rates temporarily, it was not strong enough to resist their negative pull forever:

> A contributing factor to the 2001 recession was the oppressively high levels of federal tax extracted from the economy. In the 40 years prior to 2000, federal tax receipts averaged about 18.2 percent of gross domestic product (GDP). In 1998 and 1999, the tax share stood at 20.0 percent, and in 2000, it shot up to tie the previous record of 20.9 percent set in 1944.[13]

Taxes were high because the top income tax rates were 39.6 percent and 36 percent—the same rates President Obama and Congress now target.

The economy is in a much more precarious position now than it was in the 1990s. In June 2009 alone the economy lost 467,000 jobs.[14] With no new innovations like those that created economic growth in the 1990s on the horizon to jump-start

12. Daniel J. Mitchell, "A Brief Guide to the Flat Tax," Heritage Foundation *Backgrounder* No. 1866, July 7, 2005, at *http://www.heritage.org/Research/Taxes/bg1866.cfm*.

13. J. D. Foster, "The Tax Relief Program Worked: Make the Tax Cuts Permanent," Heritage Foundation *Backgrounder* No. 2145, June 18, 2008, at *http://www.heritage.org/Research/Taxes/bg2145.cfm*.

14. Press release, "The Employment Situation: June 2009," U.S. Department of Labor Bureau of Labor Statistics, July 2, 2009, p. 1, at *http://www.bls.gov/news.release/pdf/empsit.pdf* (July 29, 2009).

growth today, the economy simply cannot afford tax policies that will destroy more jobs and make it more difficult for the economy to recover.

Myth 6: *The 2001 and 2003 tax cuts did not generate strong economic growth.*

Truth: *The tax cuts generated strong economic growth.*

The 2001 and 2003 tax cuts generated strong economic growth. The 2003 cuts, however, were more effective at creating economic growth because Congress designed them expressly for that purpose. They worked better because they increased the incentives to generate new income by accelerating the phase-in of the 2001 reduction in marginal income tax rates, and by reducing rates on capital gains and dividends, lowering the cost of capital which is critical for economic recovery and growth.

Lower income tax rates generally promote growth, but since the 2001 cuts were phased in over several years, they did not kick in quickly enough to change the behavior of workers, businesses, and investors to help boost the ailing economy, so growth remained sluggish. The 2001 cuts also increased the Child Tax Credit from $500 to $1,000 a child. Although a large tax cut from a revenue perspective, the increase in the Child Tax Credit did nothing to increase growth-promoting incentives. Recognizing that the slow phase-in of rate reductions was not generating economic growth, Congress accelerated the rate reductions to increase the incentives to work, save, and invest during the 2003 cuts.

The 2003 tax cuts also lowered rates on capital gains and dividends, generating strong growth by decreasing the cost of capital, which caused investment to increase.[15] More investment meant that more money was available for start-up capital for new businesses and for existing businesses to expand operations and add new jobs. The rate cuts on capital gains and dividends also unlocked capital trapped in investments that paid lower returns than otherwise could have been earned if the tax did not exist. This generated economic growth by allowing capital to flow freely to its most efficient use.

The increased incentives to save and invest, coupled with an acceleration of the cuts on marginal income tax rates, were a major reason economic growth picked up steam almost immediately after the 2003 tax cuts:

> The passage of [the 2003 tax cuts] started a different story. In the first quarter of that year, real GDP grew at a pedestrian 1.2 percent. In the second quarter, during which [the 2003 cuts were] signed into law, economic growth jumped to 3.5 percent, the fastest growth since the previous decade. In the third quarter, the rate of growth jumped again to an astounding 7.5 percent.[16]

Unfortunately, President Obama and Congress plan to increase the income tax rates and taxes on capital gains and dividends. This would reverse the beneficial effects of the 2001 and 2003 cuts and further slow economic growth during this severe recession.[17]

Myth 7: *Raising the top two income tax rates will not negatively impact small businesses because only 2 percent of them pay rates at that level.*

Truth: *Raising the top two income tax rates will negatively impact almost three-fourths of all economic activity created by small businesses.*

Small businesses are a vital component of the economy. They create jobs for millions of Americans and are a major factor driving economic growth.

Evaluating tax policy on the number of small businesses that pay the top two rates is not the

15. N. Gregory Mankiw and Matthew Weinzierl, "Dynamic Scoring: A Back-of-the-Envelope Guide," NBER *Working Paper* No. 11000, December 2004, pp. 15–16, at *http://www.nber.org/tmp/8655-w11000.pdf* (July 20, 2009). (Later published in *Journal of Public Economics* (September 2006).)

16. Foster, "The Tax Relief Program Worked: Make the Tax Cuts Permanent."

17. Curtis S. Dubay, "The Economic Impact of the Proposed Capital Gains Tax Increase," Heritage Foundation *WebMemo* No. 2418, April 29, 2009, at *http://www.heritage.org/Research/Taxes/wm2418.cfm*, and Curtis S. Dubay, "Obama's Dividend and Capital Gains Tax Hike Would Hurt Seniors," Heritage Foundation *WebMemo* No. 2433, May 11, 2009, at *http://www.heritage.org/Research/Taxes/wm2433.cfm*.

proper way to determine the impact of raising those rates. What is important is how much small-business income is subject to the top two rates. This measures the extent to which the top two rates affect the economic activity that small businesses create.

Using this more accurate metric, it is clear that the top two rates have an enormous impact on small businesses. According to the Treasury Department, 72 percent of small business income is subject to those rates.[18]

The amount of small business income subject to the top two rates is high in relation to the number of businesses that pay the rates because these businesses are the most successful. As a result they employ the most people and generate the most economic activity.

Raising rates on these successful businesses would damage the economy at any time, but doing so now will only cost more people their jobs. Highly successful small businesses faced with higher tax rates will cut back on plans to expand, hire fewer workers, and lower wages for current workers at a time when the economy desperately needs them to expand and create more jobs.

Higher rates also discourage would-be entrepreneurs from entering the market.[19] This will negatively affect long-term economic growth because businesses that otherwise would have been created and added jobs to the economy will never get off the starting blocks.

Conclusion

The many arguments used by proponents of higher taxes ignore basic economic facts and distort the positive benefits of the 2001 and 2003 tax cuts.

The truth is that the 2001 and 2003 tax cuts were a major factor behind robust economic growth between 2003 and 2007. Undoing those tax cuts now for any taxpayers would inflict unnecessary damage to a struggling economy and needlessly cost many more Americans their jobs.

Adding additional higher surtaxes on high earners to fund a government takeover of the health care system would only do more damage to the economy and lead to more lost jobs and lower economic growth.

Instead of imposing these economy-injuring tax hikes, Congress should close budget deficits and spur economic growth by:

- Immediately cutting spending, including reforming the Social Security, Medicare, and Medicaid entitlement programs, in order to get long-term budget deficits under control;[20]
- Making the 2001 and 2003 tax cuts permanent for all taxpayers; and
- Further cutting tax rates on workers and investors.[21]

Raising taxes on the rich will hurt the economy at a time when the U.S. can least afford further damage.

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18. U.S. Department of Treasury, "Treasury Conference on Business Taxation and Global Competitiveness," July 23, 2007, p. 15, at *http://www.treas.gov/press/releases/reports/07230%20r.pdf* (July 15, 2009).
19. William M. Gentry and R. Glenn Hubbard, "'Success Taxes,' Entrepreneurial Entry, and Innovation," National Bureau of Economic Research *Working Paper* No. 10551, June 2004, at *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=556538* (June 15, 2009).
20. Brian M. Riedl and Alison Acosta Fraser, "How to Reform Entitlement Spending: A Memo to President-elect Obama," Heritage Foundation *Special Report* No. 43, January 13, 2009, at *http://www.heritage.org/Research/Budget/sr0043.cfm*.
21. J. D. Foster, "Economic Recovery: How Best to End the Recession," Heritage Foundation *WebMemo* No. 2191, January 7, 2009, at *http://www.heritage.org/Research/Economy/wm2191.cfm*.